No. 88-230

Supreme Court, U.S.
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In The
Supreme Court of the United States
October Term, 1988

SAVINGS LEAGUE OF WISCONSIN, LTD., EQUITABLE SAVINGS & LOAN ASSOCIATION, LIBERTY SAVINGS & LOAN ASSOCIATION, and MARATHON COUNTY SAVINGS & LOAN ASSOCIATION,

Appellants,

v.

WISCONSIN DEPARTMENT OF REVENUE and W. MICHAEL LEY, as Secretary of the Department of Revenue,

Appellees.

ON APPEAL FROM THE COURT OF APPEALS, DISTRICT IV, OF WISCONSIN

JURISDICTIONAL STATEMENT (AND APPENDIX)

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QUESTIONS PRESENTED

1. Whether the Wisconsin Court of Appeals improperly ruled that long-standing decisions of this Court, which provide that state taxes violate the Supremacy and Borrowing Clauses of the United States Constitution if enacted for the sole purpose of taxing income from federal obligations, are "no longer precedential."

2. Whether the Wisconsin Court of Appeals improperly ignored recent decisions of this Court in holding that the constitutionality of a tax is determined by its label as a "franchise" tax or an "income" tax, rather than by its economic effect.

3. Whether the Wisconsin corporate "franchise" tax, which includes income from federal obligations in the measure of the tax, constitutes a valid "franchise" tax within the meaning of 31 U.S.C. §3124 and the Supremacy and Borrowing Clauses of the United States Constitution.

CORPORATE PARTIES' AFFILIATIONS

All parties appearing in the proceedings below, and in this appeal, are listed in the caption. None of the parties have corporate stockholders, subsidiaries (other than wholly owned subsidiaries) or other affiliates.

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INTRODUCTORY STATEMENT

Appellants, the Savings League of Wisconsin, Ltd. (the "League") (now known as the Wisconsin League of Financial Institutions, Ltd.), and Equitable Savings & Loan Association, Liberty Savings & Loan Association, and Marathon County Savings & Loan Association (the "Associations"), appeal from a final judgment of the Wisconsin Court of Appeals, entered October 15, 1987, upholding the validity of a Wisconsin Statute, Wis. Stat. §71.01(2), which Appellants had challenged on the basis that the statute violates the laws of the United States and is repugnant to the United States Constitution.

OPINIONS BELOW

The decision of the Wisconsin Court of Appeals from which this appeal is taken is reported at 141 Wis. 2d. 918, 416 N.W. 2d. 650 (Ct. App. 1987), and is reproduced in the Appendix hereto, pp. 2a-12a. The Memorandum Decision and Order of the Circuit Court for Dane County, dated August 20, 1986, from which the appeal to the Court of Appeals was taken, is not reported, but is reproduced in the Appendix, pp. 13a-18a. The Order of the Supreme Court of Wisconsin, dated May 3, 1988, denying Appellants' Petition for Review of the Court of Appeals decision, is reproduced in the Appendix, p. 1a.

JURISDICTION

The final judgment of the Court of Appeals of Wisconsin was entered on October 15, 1987. That decision upheld the validity of a Wisconsin statute, Wis. Stat. §71.01(2), challenged by the Appellants as violating 31 U.S.C. §3124, and being repugnant to the Supremacy and Borrowing Clauses of the United States Constitution. On May 3, 1988, the Wisconsin Supreme Court denied Appellants' Petition for Review of the Wisconsin Court of Appeals' decision. Notice of Appeal was filed with the clerk of the Wisconsin Court of Appeals and with the Dane County Circuit Court on July 26, 1988. Appendix, p. 19a.

The jurisdiction of this Court is invoked under 28 U.S.C. §1257(2) because there has been drawn in question the validity of a state statute on the grounds of it being repugnant to the laws of the United States and the United States Constitution, the decision below having been in favor of its validity.

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

CONSTITUTIONAL PROVISIONS

Supremacy Clause, U.S. Const., Art. VI, cl. 2:

> This Constitution and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Borrowing Clause, U.S. Const. Art. I, §8, cl. 2:

> Section 8. The Congress shall have Power...To borrow money on the credit of the United States.

FEDERAL STATUTES

31 U.S.C. §742

(Current version at 31 U.S.C. §3124(a))

Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

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31 U.S.C. §3124(a)

(a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except–

(1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and

(2) an estate or inheritance tax.

WISCONSIN STATUTES

Wis. Stat. §71.01
Imposition of tax: exempt income

(2) Franchise tax on corporations. For the privilege

of exercising its franchise or doing business in this state in a corporate capacity . . . every domestic or foreign corporation . . . shall annually pay a franchise tax according to or measured by its entire net income of the preceding income year at the rates set forth in s. 71.09(2m). Every corporation organized under the laws of this state shall be deemed to be residing within this state for the purposes of this franchise tax. All provisions of chs. 71 and 73 relating to net income taxation of corporations shall apply to franchise taxes imposed under this subsection, unless the context requires otherwise.

Wis. Stat. §71.03
Gross income and exclusions

(1) Inclusions. "Gross income", as used in determining taxable income of corporations under this chapter, shall include:

* * *

(c) All interest derived from money loaned or invested in notes, mortgages, bonds or other evidence of debt of any kind whatsover.

(d) All dividends.

STATEMENT OF THE CASE

On May 6, 1983, the Savings League of Wisconsin, Ltd. (the "League") and the other named Savings and Loan Associations (the "Associations") filed a complaint in state court, seeking a declaratory judgment against the Wisconsin Department of Revenue and its Secretary, W. Michael Ley (the "DOR"). The complaint challenged the validity of Wis. Stat. §71.01(2), which imposes a tax labeled the Wisconsin "Franchise Tax on Corporations." This tax, as administered by the DOR, subjects the Associations to a tax on income earned from obligations of the United States government.

Prior to 1965, Wisconsin imposed a corporate income tax on all corporations doing business in the State; this tax properly excluded all income earned by such corporations from obligations of the United States Government. Wis. Stat. §71.01(1) (1963). In 1965, the Wisconsin legislature made certain changes in this law, with the undisputed purpose of enabling the state to tax previously exempt federal income. Chapter 163, Wisconsin laws of 1965. This goal was to be accomplished by taking two steps. First, the legislature changed the title of Chapter 71, Wisconsin statutes, from "Tax on Incomes for State and Local Revenues," to "Income and Franchise Taxes for State and Local Revenues." Second, it subjected virtually every corporation which previously had been subject to a corporate "income" tax to a new "franchise" tax allegedly imposed for "the privilege of exercising its franchise in the state in a corporate capacity." In calculating the taxable income of those few corporations still subject to the "income tax," the DOR has excluded–as it had at all times since 1913–income from obligations of the United States government. In calculating the taxable measure of the "franchise" tax, however, the DOR has included income from these federal obligations. Except for this difference with respect to the treatment of income from federal obligations, the "franchise" and "income" taxes are calculated, collected, paid, assessed and otherwise administered in virtually identical

fashions. The Associations are subject to the Wisconsin "franchise" tax and have, at all times since they became subject to the tax in 1965, been required to include income from federal obligations in the measure of the franchise tax.

Appellants contended in the proceedings before the Dane County, Wisconsin Circuit Court that Wisconsin's corporate "franchise tax," to the extent it included income from federal obligations in the measure of the tax, was proscribed by 31 U.S.C. §3124 and was repugnant to the Supremacy and Borrowing Clauses of the United States Constitution. Specifically, Appellants argued that (1) the Wisconsin corporate "franchise" tax is in reality an "income" tax, which indisputably cannot include income from federal obligations in the tax base; (2) even if the "franchise" tax is actually a "franchise" tax, it is nevertheless invalid because the legislature enacted the provision solely for the purpose of taxing income from federal obligations, and (3) regardless of how the tax is labeled, the economic effect of the tax (which in this case is to reach income from federal obligations) demonstrates that the tax is unconstitutional. In a Memorandum Decision and Order dated August 20, 1986, the Circuit Court addressed the first argument, holding that the "Wisconsin franchise tax is not an income tax." Appendix, p.13a. The Circuit Court did not address the second and third arguments.

Appellants then filed an appeal with the Wisconsin Court of Appeals, again raising each of the issues sought to be reviewed in this Court. On October 15, 1987, the Court filed an opinion holding that Wis. Stat. §71.01(2) does not violate 31 U.S.C. §3124 and the Supremacy and Borrowing clauses of the United States Constitution because (1) the corporate "franchise" tax is a nondiscriminatory franchise tax within the meaning of 31 U.S.C. §3124, Appendix, pp.5a-8a, and (2) decisions of this Court, which "support the taxpayer's position" that a tax is unconstitutional if enacted solely for the purpose of taxing income from federal obligations, "are no longer precedential." Appendix,

p. 9a. The Court of Appeals did not address explicitly the question of whether the economic effect of a tax is the true test of its constitutionality.

On November 16, 1987, the Appellants then filed with the Wisconsin Supreme Court a Petition for Review of the Court of Appeals decision. The Wisconsin Supreme Court issued an order denying the Petition for Review on May 3, 1988. Appendix, p. 1a.

THE QUESTIONS ARE SUBSTANTIAL

Introduction

Since the United States Supreme Court decision in *Weston v. City Council of Charleston*, 27 U.S. (2 Pet.) 449 (1829), it has been a fundamental federal constitutional principle that obligations of the federal government are immune from state taxation. This principle is derived from the Borrowing and Supremacy Clauses of the United States Constitution and the constitutional doctrines announced in *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819), and it is aimed at protecting the borrowing power of the United States from state encroachment. *Society for Savings v. Bowers*, 349 U.S. 143, 144 (1955). As stated by the Supreme Court, this doctrine is intended:

> to prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit.

Smith v. Davis, 232 U.S. 111, 117 (1944). This constitutional doctrine has been embodied in a succession of federal statutes, most recently in 31 U.S.C. §3124.[1]

As befits its broad purpose, this doctrine has been applied by this Court to bar *indirect* taxes as well as

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[1] The original Congressional expression of this constitutional doctrine, the Act of Feb. 25, 1862, Ch. 33, §2, 12 Stats. 346, exempted all "stocks, bonds and other securities of the United

(Footnote continued on the following page)

direct taxes on federal obligations, thereby prohibiting state taxes on the income derived from such obligations as well as taxes on the obligations themselves. For example, in *Northwestern Ins. Co. v. Wisconsin*, 275 U.S. 136 (1927), this Court examined a Wisconsin tax on life insurance companies. The tax ostensibly was imposed as a license fee for the privilege of transacting life insurance business within the state and it was measured by the gross income of the taxpayer, including income derived from United States bonds. This Court rejected Wisconsin's argument that the tax was an assessment on the corporate franchise rather than on the federal obligations themselves, and it invalidated the tax. The Court reasoned as follows:

> Here the statute undertook to impose a charge of 3 percent upon every dollar of interest received by the Company from United States bonds. So much, in any event, the State took from these receipts. This amounts, we think, to an imposition upon the bonds themselves and goes beyond the power of the State.

Id. at 141. Similarly, in *Gillespie v. State of Oklahoma*, 257 U.S. 501,505 (1922), this Court concluded that:

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1 *(continued)*

States held by individuals, corporations or associations" from state taxation. This and several related statutes were the predecessors to Rev. Stat. §3701 (1878 ed.) (31 U.S.C. §742), which was placed on the books in 1873 and which provided that all federal bonds and obligations "shall be exempt from taxation by or under state or municipal authority."

In 1959, Congress amended Rev. Stat. §3701 (1878 ed.) to provide that the tax exemption "extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax." Exceptions were provided for "nondiscriminatory franchise taxes or other nonproperty taxes in lieu thereof imposed on corporations," and for "estate or inheritance taxes." Act of Sept. 22, 1959, Pub L. No. 86-346, §105, 73 Stat. 622. Title 31 of the United States Code was enacted into positive law in 1982, at which time Section 3701 was recodified at 31 U.S.C. §3124(a) without substantive change. Full texts of the 1959 legislation and 1982 compilation appear *supra*, at p. 4.

> In cases where the principal is absolutely immune from interference an inquiry is allowed into the sources from which net income is derived and if a part of it comes from such a source the tax is *pro tanto* void.

The fundamental issue in this appeal is whether the State of Wisconsin, merely by relabeling its corporate "income" tax as a "franchise" tax, can circumvent these constitutional and statutory barriers against state taxation of income from federal obligations. The Wisconsin Court of Appeals decided in the affirmative, holding that despite the basic operational identity of the "franchise" tax with an impermissible income tax on federal obligations, the tax is a valid "franchise" tax under 31 U.S.C. §3124 and the Supremacy and Borrowing Clauses of the United States Constitution. In reaching its conclusion, the Wisconsin Court of Appeals (1) decided that two decisions of this Court, *Miller v. Milwaukee*, 272 U.S. 713 (1927) and *Macallen v. Massachusetts*, 279 U.S. 620 (1929) (holding that state taxes are unconstitutional if adopted for the "evident" or "obvious" purpose of taxing income from federal obligations) are "no longer precedential," Appendix, p. 9a; (2) ignored another decision of this Court, *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), which held that regardless of the classification of a tax, the economic effect of the tax determines its constitutionality; and (3) decided that the Wisconsin "franchise" tax met the test of a bona fide "franchise" tax established by this Court in *Educational Films Corp. v. Ward*, 282 U.S. 379 (1931), a case that examined a 1929 New York tax that, as will be examined below, is completely distinguishable from the Wisconsin tax.

This appeal therefore places three substantial federal questions before this Court for review. Having said this, it should also be noted that several other recent appeals have been filed with this Court that involved State franchise taxes measured at least in part by income from federal obligations. *See e.g., First Union National Bank of Florida v. Dept. of Rev.*, 513 So. 2d 114 (Fla. 1987), *appeal dismissed*,

108 S.Ct. 1253 (1988) (Blackmun, J. would have noted probable jurisdiction); *First American National Bank of Knoxville v. Taylor*, No. 270, slip. op. (Tenn. 1987), *appeal dismissed*, 108 S.Ct. 1460 (1988) (Blackmun, J. would have noted probable jurisdiction); *Garfield Trust Co. v. Director, Div. of Tax*, 508 A.2d 1104 (N.J. 1986), *appeal dismissed*, 107 S.Ct. 390 (1986). None of these appeals, however, presented issues involving (1) a state court's explicit rejection of concededly relevant United States Supreme Court precedents involving impermissible legislative motive in attempting to tax income from federal obligations; and (2) the application of this Court's decision in *Complete Auto* to a tax that has precisely the same economic effect on federal obligations as an impermissible income tax. Furthermore, while several of these cases quite clearly were decided on the basis of this Court's decision in *Educational Films*, none addressed the vitality of *Educational Films* in light of *Complete Auto*, and *none* presented the question of whether a statutory scheme lacked the essential features of the bona fide "franchise" tax examined in *Educational Films*.

1. The Wisconsin Court of Appeals Improperly Ruled that Long-Standing Decisions of this Court, which Provide that State Taxes Violate the Supremacy and Borrowing Clauses of the United States Constitution if Enacted for the Sole Purpose of Taxing Income from Federal Obligations, "are no longer precedential."

Prior to 1965, the Wisconsin corporate income tax did not and could not reach income earned by a corporation from federal obligations owned by it. In 1965, however, the Wisconsin legislature amended the corporate income tax law, primarily by renaming the tax a "franchise" tax; it is undisputed that the sole purpose of this amendment was to enable the State to tax this previously exempt federal income. Appellants argued in the Wisconsin Court of Appeals that, under two long-standing decisions of this Court, the legislative purpose behind the 1965 amendment

was sufficient by itself to invalidate that law, but the Wisconsin Court of Appeals concluded that the cited cases "are no longer precedential." Appendix, p. 9a. Appellants are contending here that these United States Supreme Court cases in question have never been overruled and that, therefore, the Wisconsin Court of Appeals was without authority to ignore them and committed constitutional error in doing so.

The first of the United States Supreme Court cases which the Appellants have cited on this point is *Macallen v. Massachusetts*, 279 U.S. 620 (1929), which presented a fact pattern virtually identical to the fact pattern in this case. In *Macallen*, the Commonwealth of Massachusetts imposed an "excise" tax on corporations doing business within the state. Prior to a statutory amendment in 1925, the measure of the tax excluded interest earned by corporations on federal obligations. In 1925, however, the legislature eliminated that exclusion. The Commonwealth argued that the tax, as so modified, was permissible, pointing to earlier cases which had seemingly upheld "franchise" taxes even if such taxes indirectly took into account the value of, or the income from, United States bonds. This Court, however, had little difficulty distinguishing the earlier precedents from the situation before it. The Court stated that, in those earlier cases, it was implicit that:

> [T]he thing taxed in form was in fact and reality the subject aimed at, and that any burden put upon the non-taxable subject by its use as a measure of value was fortuitous and incidental.

279 U.S. at 628. By contrast, the history of the tax in the case before it disclosed that the sole purpose of the 1925 change was to reach a non-taxable subject, i.e., the bond income, meaning that the impact on such income was intended and was not "fortuitous and incidental" as in the earlier cases. The Court noted that:

> In the present case, it appears that the original statute exempted from consideration as a part of the measure of the tax all interest upon the non-

> taxable securities. The amended tax now in force has the effect of repealing this original provision and imposing a burden upon the securities for which, by express language, they had theretofore been free. This was a distinct change of policy on the part of the Commonwealth, adopted, as though it had been so declared in precise words, for the very purpose of subjecting these securities *pro tanto* to the burden of the tax.

Id. at 631 (emphasis in original). This purpose, the Court concluded, distinguished the case before it from the earlier precedents and required that the 1925 enactment be invalidated. And *see similarly Miller v. Milwaukee*, 272 U.S. 713 (1927), where the State of Wisconsin sought to impose a shareholder-level income tax on the pro-rata portion of dividends paid to Wisconsin shareholders by Wisconsin corporations holding United State bonds. This Court invalidated the tax on the basis that the purpose of the tax was to tax otherwise untaxable income from Federal bonds, reasoning that:

> It is a familiar principle that conduct which in usual situations the law protects may become unlawful when part of a scheme to reach a prohibited result. *If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result, the statute must fail even if but for its purpose or specific operation it would be perfectly good.*

Id. at 715 (emphasis supplied).

In the instant case, the Wisconsin Court of Appeals conceded that *Macallen* and *Miller* contained "language" which supports the Appellants' position, Appendix at p. 9a, but made an extraordinary decision not to follow those cases, holding instead that, in its opinion, the legislative purpose in enacting the 1965 legislation was irrelevant. This conclusion, however, is in error, inasmuch as it is axiomatic that a lower court has no authority to ignore or overrule a decision of the United States Supreme Court. *See e.g., Thurston Motor Lines, Inc. v. Jordan K. Rand,*

Ltd., 460 U.S. 533 (1983), in which this Court chastised a federal Court of Appeals for ignoring a 1918 Supreme Court decision. As in the instant case, the Court of Appeals in *Thurston Motor Lines* had expressed its "doubt" that the 1918 case was still "good law" but, as the Supreme Court pointed out, "only *this* Court may overrule one of its precedents and, until that occurs, the precedent remains controlling." *Id.* at 435 (emphasis supplied).

The Wisconsin Court of Appeals attempted to justify its decision not to reach the conclusion mandated by *Macallen* and *Miller* by concluding that the holdings of these cases have been so "eroded" by later decisions that the earlier cases are no longer of precedential value. There are, however, several fatal flaws in this reasoning.

For one thing, as noted above, only this Court can overrule its own precedents and even the Appellees would have to concede that both *Macallen* and *Miller* have never been overruled. In fact, *Macallen* has been cited favorably by this Court in several recent tax cases involving state taxation of federal obligations (although not on the specific point under consideration here). *See Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 396 n.5 (1983); *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 866 n.11 (1983).[2]

Moreover, in the cases cited by the Wisconsin Court of Appeals as demonstrating the "erosion" of the *Macallen* and *Miller* doctrine, this Court explicitly stated that it was *not* overruling the earlier precedents, even though it could have done so had it so desired. *See Pacific Co. v. Johnson*, 285 U.S. 480 (1932); *Tradesmens National Bank v. Tax Comm'n*, 309 U.S. 560, 566 (1940). Instead, in each of these cases, this Court stated that *Macallen* and *Miller*

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[2] The Supreme Courts of the State of Rhode Island and Washington also have concluded or assumed that *Macallen* is still good law. *See Federal Products Corp. v. Norberg*, 429 A.2d 447 (R.I. 1981); *Power, Inc. v. Huntley*, 39 Wash. 2d 191, 235 P.2d 173 (1951).

were factually distinguishable. In *Pacific Co.*, for instance, the Court stated that the California legislature had "indulged in no reversal of policy so far as measurement of the franchise tax is concerned." Rather, the legislative history disclosed only that California "had sought in good faith, to conform its scheme of taxation of corporations to a permitted method of taxing national banks. . . ." *Id.* at 491. Similarly, in *Tradesmens National Bank*, the Court stated:

> It cannot be said that the Oklahoma tax in question here was aimed at tax-exempt federal securities in the manner disclosed and condemned in the *Macallen* case. The history of the Oklahoma legislation on this subject discloses only that it sought to change its policy pursuant to the express authorization conferred by [Federal Statute] R.S. §5219.

309 U.S. at 566. In deciding that the earlier cases had been overruled, the Wisconsin Court of Appeals necessarily concluded that this Court's analysis in *Pacific Co.* and *Tradesmens National Bank* was disingenuous.[3] Appellants submit that this peculiar conclusion requires the closest review by this Court.

2. The Wisconsin Court of Appeals Improperly Ignored this Court's Decision in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), which Held that the Constitutionality of a Tax is Determined by its Economic Effect, Regardless of its Classification as a "Franchise" or an "Income" tax.

The Appellants argued in the Wisconsin courts that the economic effect of the Wisconsin "franchise" tax, inasmuch as it is measured solely by corporate income, is no different than a corporate income tax. Therefore, since it

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[3] It is important to point out that the Wisconsin Court of Appeals in this case did not base its conclusion on the ground that the instant case is closer on its facts to *Pacific Co.* and *Tradesmens National Bank* than to *Miller* or *Macallen*. Rather, it decided to ignore the earlier cases altogether because the Court of Appeals had concluded that they were no longer good law.

is undisputed that a state cannot impose an income tax on the income earned by its taxpayers from federal obligations, it follows that an economically identical "franchise" tax must similarly be invalidated.

This principle, that the economic consequences of a tax and not its formal classification is the touchstone by which the constitutionality of a tax is determined, is of relatively recent vintage, as illustrated by this Court's decision in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). *Complete Auto* involved a "privilege" tax imposed by the State of Mississippi on a taxpayer whose sole activity in Mississippi consisted of interstate commerce. The taxpayer, relying on *Spector Motor Service, Inc. v. O'Connor*, 340 U.S. 602 (1951), argued that the tax was impermissible under the Commerce Clause. *Spector* had involved a Connecticut franchise tax, imposed on a corporation for the privilege of doing business in Connecticut and measured by the corporation's apportioned net income; the Mississippi Supreme Court invalidated the tax on the grounds that the Commerce Clause did not permit a "franchise" tax to be imposed on a purely interstate business despite the fact that an identically structured "income" tax *would* be permissible. In *Complete Auto*, though, this Court recognized the absurdity and practical impossibility of distinguishing between a "franchise" tax measured by income and an "income" tax and therefore overruled its decision in *Spector*. The Court stated,

> The reason for attaching constitutional significance to a semantic difference is difficult to discern. . . . There is no economic consequence that follows necessarily from the use of the particular words "privilege of doing business" and a focus on that formalism merely obscures the question whether the tax produces a forbidden effect.

430 U.S. at 285, 289.[4]

In this case, the State of Wisconsin is attempting to give *immense* and *determinative* "economic consequences" to the words "privilege of doing business," since it is the 1965 addition of those words to the former income tax law which, the State contends, permits it to reach federal income that the prior "income" tax could concededly not reach. Applying this Court's reasoning in *Complete Auto* to the case at bar, however, it is impossible to discern any reason for "attaching constitutional significance" to this 1965 verbiage. To the extent that earlier cases imply that there are formalistic distinctions between these taxes that exclude a consideration of their identical economic impact, it is submitted that these cases are of no more current significance than the now discredited *Spector Motor Service* case.[5]

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[4] The formalistic nature of the *Spector* rule was highlighted in *Railway Express Agency v. Virginia*, 347 U.S. 359 (1954) ("Railway Express I") and *Railway Express Agency v. Virginia*, 358 U.S. 434 (1959) ("Railway Express II"). In *Railway Express I*, the Supreme Court invalidated a Virginia franchise tax on the basis of *Spector*, following which the State revised the wording of the tax so as to avoid the franchise/privilege tax terminology. In *Railway Express II*, this latter approach was upheld.

[5] The Pennsylvania Supreme Court recently reached the same conclusion. *See C. C. Collings & Co., Inc. v. Comm.*, 514 A.2d 1373 (1986), *aff'g per curiam* 488 A.2d 1187 (Pa. Commn. 1985). The court determined that a tax, ostensibly imposed "on the privilege of doing business" and measured by corporate income, was simply an income tax in disguise. Citing *Complete Auto Transit v. Brady*, the court reasoned that "there is no economic consequence that follows necessarily from the use of the particular words 'privilege of doing business' and a focus on that formalism merely obscures the question. . . ." 488 A.2d at 1193. *Accord First Federal Savings and Loan Association of Philadelphia v. Comm.*, 528 A.2d 942 (Pa. 1987) (Pennsylvania Mutual Thrift Institution Act also imposes a direct tax on net income, rather than a tax on the privilege of doing business in the state).

3. The Wisconsin Corporate Franchise Tax, which Includes Income from Federal Obligations in the Measure of the Tax, is not a Franchise Tax Within the Meaning of 31 U.S.C. §3124 and the Supremacy and Borrowing Clauses of the United States Constitution.

The Appellants argued in the courts below that the corporate "franchise" tax imposed by Wis. Stat. §71.01(2) is not a bona fide franchise tax within the meaning of 31 U.S.C. §3124. From a constitutional perspective, this question is of vital importance because, although it has long been held that obligations of the federal government are immune from state taxation, and although this doctrine has been held to apply to state income taxes, it has also been held not to apply to true "franchise" taxes. *Werner Machine Co. v Director of Div. of Taxation*, 350 U.S. 492 (1956). Similarly, from a statutory perspective, Congress amended 31 U.S.C. §3124 in 1959 to insure that federal immunity extended to "every form of taxation that would require the [federal] obligations or the interest thereon, or both to be considered, directly or indirectly, in the computation of the tax;" however, Congress excepted from this rule "nondiscriminatory franchise" taxes.

In the decisions below, the Wisconsin courts held that the Wisconsin tax was a true "franchise" tax under 31 U.S.C. §3124. The courts concluded, relying principally on *Educational Films Corp. v. Ward*, 282 U.S. 379 (1931), that the tax was a "franchise" tax because it could be imposed only if a corporation both exercises its franchise in the taxing year and has taxable income in the preceding year. To demonstrate this ostensibly critical point, the court relied on the fact that "if a corporation is dissolved, has ceased operating, or has withdrawn from Wisconsin during the tax year, it is not subject to the franchise tax. . . ." Appendix, p. 6a.

There are, however, several serious flaws to this argument.

For one thing, this treatment of a corporation during its final year may or may not be true any longer in Wisconsin as a consequence of an ambiguous amendment to the Wisconsin law in 1986. (Even more significantly, an analysis of that amendment demonstrates the absurdity of basing a vital constitutional distinction on such a trivial and cosmetic factor.) In 1986, thus, the Wisconsin legislature amended Wis. Stat. §71.01(2) to provide as follows:

> In addition, . . . a corporation that ceases doing business in this state . . . shall pay a special franchise tax according to or measured by its entire Wisconsin net income for the taxable year during which the corporation ceases doing business in this state. . . .

1985 Wisconsin Act 261, Section 1. The meaning of this change is unclear, as can be seen by hypothesizing a calendar year corporation that commences business in Wisconsin in 1988 (Year One), continues business throughout 1989 (Year Two) but goes out of business on December 31, 1989. Under the "regular" franchise tax rules, the corporation will (i) pay no franchise tax in any year for the privilege of exercising its franchise in Year One (since it earned no income in the prior year), (ii) pay (in Year Two) a franchise tax for exercising its privilege in Year Two, based on its income in Year One and (iii) pay no franchise tax in any year for the privilege of exercising its franchise in Year Three (since it did not in fact do any business in that year). Under the amendment described above, however, there is an additional franchise tax to be paid, based on Year Two income, but it is unclear whether this tax is for the privilege of exercising the corporation's franchise in the year of payment or for the prior year. If the former interpretation is correct, it can be seen that the Court of Appeals was wrong, in that the franchise tax is payable for a year in which the franchise is not in fact being exercised. If the latter interpretation is correct, the absurd result is that the corporation will pay two franchise taxes for Year Two, one payable in Year Two and the other payable in Year Three, while another corporation exercising precisely

the same privileges in Year Two but continuing in business into Year Three would pay only one such tax. Whatever the meaning of the 1986 amendment, therefore, the attempt by the Court of Appeals to base its decision on a statutory linkage between the imposition of the tax and the exercise of the franchise can be seen to be erroneous as a matter of law and logic.

Moreover, even if the franchise tax was payable only for years in which the franchise is exercised, that is true of an income tax as well and this factor therefore provides no basis for identifying a "true" franchise tax. Thus, it is necessary to examine other operational aspects of the tax. And, when that is done, it is evident that the incidence of the Wisconsin tax is (unlike the tax in *Educational Films*) the receipt of *income*, rather than the exercise of the corporate franchise.

First, under the Wisconsin Statute, it is possible for a corporation exercising a substantial franchise in Wisconsin to pay no tax at all if, for various reasons (such as deductions, net operating loss carryforwards, tax credits, and so on), it has no taxable *income*. Under the New York Statute examined in *Educational Films*, however, virtually every corporation was required, regardless of net income, to pay a "minimum tax" for the "privilege of exercising its franchise in the state." N.Y. Tax Law Article 9-A, §214(10) (1929) stated:

> It is further provided that *every domestic corporation for the privilege of exercising its franchise* in this state, other than one exempted by section two hundred and ten of this chapter, shall be subject to a *minimum tax of* (1) not less than ten dollars and (2) not less than one mill upon each dollar of its issued capital stock at its face value, and (3) not less than would be produced by applying a rate of two per centum to a base consisting of the entire net income plus salaries and other compensation paid to all elected or appointed officers, and to any stockholder owning in

> excess of five per centum of the issued capital stock of the corporation, excepting dividends, and after deducting from the base six thousand dollars and any deficit for the reported year; whichever would result in the largest amount of tax....

(emphasis supplied). This difference alone demonstrates that the true incidence of the Wisconsin tax, unlike the tax in *Educational Films*, is the receipt or nonreceipt of income and not the exercise of the corporate franchise.[6]

Second, Wis. Stat. § 71.042(1) permits a Wisconsin corporation to avoid the "franchise" tax entirely if it elects so-called "Subchapter S" status and if its shareholders report in their net income (for personal income tax purposes) their respective shares of the corporation's net income. This provision (which had no counterpart in the 1929 New York tax statute) could not logically exist if the Wisconsin corporate tax were a true "franchise" tax, since an "S" corporation exercises its corporate privilege to no less an extent than

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[6] This conclusion (i.e., that a tax cannot be deemed a true "franchise" tax unless the tax bears some relationship to the exercise of that franchise and does not merely depend on corporate income) was recognized in *Power, Inc. v. Huntley*, 39 Wash. 2d 191, 235 P.2d 173 (1951), a case involving another tax ostensibly imposed on corporations for "the privilege of exercising their franchise" and measured by corporate income. Like the Wisconsin tax, however, it was possible under that statutory scheme to exercise a substantial franchise yet pay no "franchise" tax. The Washington Supreme Court reasoned that this disjunction between exercise of the "franchise" and payment of the tax demonstrated that the tax was in reality an income tax:

> After studying this act in its entirety, *we conclude that the tax is levied because the corporation has net income, not because it does any business* in this state or exercises its corporate franchise; conversely, if *it has done a million dollars worth of business in this state but has no net income, it would not be subject to taxation under this act.*

235 P.2d at 177 (emphasis supplied).

its non-"S" competitors.[7]

Third, under Wis. Stat. §71.01(2), a corporation that begins and ends its Wisconsin operations in a single year would be exempted from paying *any* franchise tax for that year, even though it obviously exercises its franchise in the state in that year. Similarly, as already noted, a corporation that begins business in one year and continues operating in subsequent years pays no "franchise" tax for its first year, as the tax is imposed for the privilege of exercising its franchise in one year, based on the *preceding* year's income (which would be zero). In contrast, under the New York statute examined in *Educational Films*, a corporation would in both instances pay a tax on its exercise of the corporate privilege during that year. N.Y. Tax Law Article 9-A, §214(10) (1929).

Fourth, Wis. Stat. §71.01(2) excepts from the so-called franchise tax any corporation whose Wisconsin business consists exclusively of foreign commerce, interstate commerce or both. Whatever the reason for this exception, there is no logical basis for excluding such a corporation from a bona fide franchise tax, as it is exercising its corporate franchise in the same manner and to the same degree as a corporation not so excluded.

The confluence of the above factors, then, demonstrates quite clearly that the incidence of the Wisconsin tax, quite unlike the New York tax in *Educational Films*, is the receipt or non-receipt of income and not the exercise of the corporate franchise in the state. Accordingly, the

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[7] On November 19, 1987, while a Petition to Review this case was pending with the Wisconsin Supreme Court, the Wisconsin legislature amended Wis. Stat. §71.042(2) so that, effective for the 1987 taxable year, an S corporation's income from federal obligations cannot be passed through (for tax purposes) to its shareholders. The result of this curious statutory amendment is that Wisconsin S corporations must now pay a corporate "franchise" tax measured *solely* by income from federal obligations. Income from similar *state* obligations is *not* included in the taxable base of this new "franchise" tax.

conclusion is inescapable that the Wisconsin tax does not qualify as a true "franchise" tax under 31 U.S.C. §3124.

Furthermore, the same result follows from an analysis of the congressional intent behind a 1959 amendment to 31 U.S.C. §3124. That amendment added the following sentence to the statute:

> This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

The history and purpose of this amendment was discussed by this Court in *American Bank and Trust Co. v. Dallas County*, 463 U.S. 855 (1983). The Court there pointed out that the additional language was added to the statute in response to the assertion, by several states, that the law as it was previously worded permitted a tax on income derived from federal obligations as long as the tax was imposed on the taxpayer rather than on the income. The State of Idaho was particularly aggressive in this assertion and intended to enforce its individual income tax accordingly, but Congress modified 31 U.S.C. §3124 to prevent this very formalistic interpretation. The Supreme Court in *American Bank* explained the congressional action as follows:

> Idaho relied on the formal distinction between a tax on an individual, measured be his net income, and a tax on the income itself.... To answer this argument, the amendment abolished the formalistic inquiry whether the tax is on a distinct interest, and replaced it with the inquiry whether a computation of the tax requires consideration of federal obligations.

Id. at 867.

It is true that the 1959 amendment was prompted primarily by individual and not corporate income tax consid-

erations but, as this Court pointed out in *American Bank*, Congress did not intend to limit the new approach to just individual income taxes, 463 U.S. at 866-67, and it intended, rather, to reject and set aside the Supreme Court's "formalistic" pre-1959 approach to the entire statute. 463 U.S. at 862. Moreover, while it is also true that Congress provided an exemption from the 1959 amendment for corporate "franchise" taxes, it cannot have meant franchise taxes based on income, since it is irrational to believe that Congress intended to preserve in the corporate income tax context precisely the same "formalistic inquiry" (i.e., between taxes "on" federal obligations and taxes on a transaction or interest measured by those obligations) which it was rejecting in the individual income tax context. Based on the 1959 amendment, then, Congress could only have meant "franchise" taxes to include the traditional types of franchise taxes, in which the incidence of the tax is truly on the exercise of the corporate privilege and in which the measure of the tax is somehow related to the magnitude of that exercise. *See American Bank*, 463 U.S. at 863, noting that franchise taxes "customarily asses the franchise. . .at the value of the assets of the business."

In summary, both the structure of the Wisconsin tax and the legislative history behind 31 U.S.C. §3124 support the conclusion that, even if the Wisconsin approach would have been sanctioned by the courts prior to 1959, that approach is no longer valid under 31 U.S.C. §3124.

CONCLUSION

For these reasons, this Court should note probable jurisdiction and set the case for plenary consideration.

Respectfully submitted,

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APPENDIX

Office of the Clerk
Supreme Court
State of Wisconsin

Hon. Angela Bartell
Circuit Court for Dane County
City-County Bldg.
Madison, WI 53709

To: Robert A. Schnur
Michael, Best & Friedrich
250 East Wisconsin Avenue
Milwaukee, WI 53202

Madison, May 3, 1988

Edward S. Marion
Asst. Attorney General
P. O. Box 7857
Madison, WI 53707-7857

The Court today announced an order in your case as follows:

No. 86-1825

Savings League of Wisconsin, Ltd., et al. v. WI DOR, et al.
(T.C. #83 CV 2318)

A petition for review pursuant to sec. 808.10, Stats., having been filed on behalf of plaintiffs-appellants- petitioners, Savings League of Wisconsin, Ltd., Equitable Savings & Loan Association, Liberty Savings & Loan Association and Marathon County Savings & Loan Association, and considered by the court,

IT IS ORDERED that the petition is denied, without costs.

MARILYN L. GRAVES
Clerk of Supreme Court

No. 86-1825

State of Wisconsin
In Court of Appeals
District IV

SAVINGS LEAGUE OF WISCONSIN, LTD., EQUITABLE SAVINGS & LOAN ASSOCIATION, LIBERTY SAVINGS & LOAN ASSOCIATION, and MARATHON COUNTY SAVINGS & LOAN ASSOCIATION,

Plaintiffs-Appellants,

v.

WISCONSIN DEPARTMENT OF REVENUE and W. MICHAEL LEY, as Secretary of Department of Revenue,

Defendants-Respondents.

Appeal from a judgment of the circuit court for Dane county: **Angela B. Bartell, Judge.** *Affirmed.*

[FILED OCTOBER 15, 1987]

Before Gartzke, P.J., Eich, J. and Sundby, J.

SUNDBY, J. This appeal is from a summary judgment declaring constitutional sec. 71.01(2), Stats.,[1] which imposes on domestic corporations an annual franchise tax for the privilege of doing business in the state. The appellants are the Wisconsin League of Financial Institutions, Ltd., formerly the Savings League of Wisconsin, Ltd., on behalf of itself and all other corporations doing business

[1] References to the statutes are to the 1983-84 statutes unless otherwise noted. The trial court made no declaration as to the effect of the amendment to sec. 71.01(2), Stats., by 1985 Wis. Act 261 and that amendment is not before us.

savings and loan associations on their own behalf and on behalf of other savings and loan associations similarly situated.

The taxpayers claim that sec. 71.01(2), Stats., violates the supremacy clause, art. VI of the federal constitution, the borrowing clause, art. 1, sec. 8, cl. 2 of the federal constitution, and 31 U.S.C. sec. 3124 (1982), to the extent that a tax is imposed on income earned on federal obligations. They also argue that if sec. 71.01(2) imposes what would otherwise be a valid corporate franchise tax, that the tax is nevertheless invalid because its principal purpose is to reach otherwise unreachable income earned on federal obligations. We conclude that sec. 71.01(2) does not violate the supremacy or borrowing clauses of the United States Constitution or 31 U.S.C. sec. 3124 and therefore affirm.

I.

BACKGROUND OF THE CASE

The facts are stipulated. The Wisconsin legislature first enacted a corporate income tax in 1911. Ch. 658, Laws of 1911. Income earned on federal stocks and other obligations was excluded from the corporation's taxable income. In 1965 the title of ch. 71, Stats., was changed from "Tax on Incomes for State and Local Revenues" to "Income and Franchise Taxes for State and Local Revenues." Sec. 74ab, ch. 163, Laws of 1965. Section 71.01(1), Stats. (1963), which had imposed an income tax on all "persons" was amended to apply to "natural persons," certain trusts, and "every corporation not subject to the franchise tax under sub. (2), which owns property within this state or whose business within this state during the taxable year consists exclusively of foreign commerce, interstate commerce, or both." Sec. 74ad, ch. 163, Laws of 1965.

Section 71.01(2), Stats. (1965), was created to read:

> For the privilege of exercising its franchise or doing business in this state in a corporate capacity every domestic or foreign corporation, except corporations specified in sub. (3), shall annually pay a franchise tax according to or measured by its entire net income of the preceding income year at the rates set forth in s. 71.09(2am). Every corporation organized under the laws of this state shall be deemed to be residing within this state for the purposes of this franchise tax. All provisions of chs. 71 and 73 relating to net income taxation of corporations shall apply to franchise taxes imposed under this subsection, unless the context requires otherwise . . . .

Sec. 74af, ch. 163, Laws of 1965.

Since the effective date of this section the department of revenue in computing the net income subject to a corporate franchise tax under sec. 71.01(2), Stats., has included all income earned on stocks and obligations of the United States. The department, however, excludes such income from the net taxable income of corporations not subject to the franchise tax. The department administers the laws imposing franchise tax on corporations in a way almost identical to the way it administers the corporate income tax law. The department's instruction booklet for the 1965 corporate franchise or income tax return stated that the franchise tax differed from the corporate income tax only "in that it requires that income derived from obligations of the United States government and its instrumentalities be included in the determination of the entire net income."

II.

MAY SECTION 71.01(2), STATS., INCLUDE INCOME FROM FEDERAL OBLIGATIONS?

The taxpayers argue that the borrowing and supremacy clauses[2] of the United States Constitution prohibit taxes on the income derived from federal obligations as well as taxes on the obligations themselves. They claim that since sec. 71.01(2), Stats., imposes a tax on income earned by corporate taxpayers, the tax is unconstitutional to the extent that it is imposed on income earned on federal obligations.

The taxpayers' arguments were answered contrary to their position in *Educational Films Corp. v. Ward*, 282 U.S. 379 (1931). The New York tax law levied an annual tax on every domestic corporation of certain classes "for the privilege of exercising its franchise in this state in a corporate or organized capacity." The tax was levied on so much of the corporation's net income for its preceding fiscal year as was allocated to its business carried on within the state. Net income included all dividends received on stocks and all interest received from federal, state, municipal or other bonds.

Educational Films challenged the tax assessed against it, insofar as the tax was measured by royalties received from the licensing of copyrights granted by the United

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[2] The borrowing clause, art 1, sec. 8, cl. 2, U.S. Const., provides: "The Congress shall have the power [t]o borrow money on the credit of the United States." The supremacy clause, art. VI, U.S. Const., provides:

> This constitution, and the laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the constitution or law of any state to the contrary notwithstanding.

States upon motion picture films. The court assumed for decision making purposes that the tax was a tax on federal instrumentalities. *Educational Films*, 282 U.S. at 386.

Educational Films contended, as do the taxpayers here, that the so-called franchise tax was in reality a tax on income, and as such fell within the class of taxes which could not be directly imposed on federal instrumentalities. The Supreme Court responded to this argument as follows:

> But the nature of a tax must be determined by its operation rather than by particular descriptive language which may have been applied to it. As was said in *Macallen Co. v. Massachusetts*, "neither state courts nor legislatures, by giving the tax a particular name, or by using some form of words, can take away our duty to consider its nature and effect."
>
> If we look to the operation of the present statute, it is plain that it can have no application independent of the corporation's enjoyment of the privilege of exercising its franchise. If appellant had ceased to do business before November 1, 1929, it would not have been subject to any tax under this statute, although it had received, during its preceding fiscal year, income which the statute makes the measure of the tax. Since it can be levied only when the corporation both seeks or exercises the privilege of doing business in one year and has been in receipt of net income during its preceding fiscal year, the tax, whatever descriptive terms are properly applicable to it, obviously is not exclusively on income apart from the franchise.

Educational Films, 282 U.S. at 388 (citation omitted).[3]

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[3] We do not wish our reliance on *Educational Films* to be mistaken. We do not hold that it is the *sine qua non* of constitutionality that the corporation not be subject to the franchise tax if it ceases operating within the state during the tax year. However, that qualification exists as to the franchise tax imposed by sec. 71.01(2), Stats., and *Educational Films* establishes that such is sufficient to set a franchise tax apart from an income tax.

The taxpayers argue that "if a tax looks like an income tax, sounds like an income tax and operates like an income tax, at some point it becomes an income tax and must stand or fall accordingly." They argue that point has been passed here. There is, however, a distinguishing feature between an income tax and a franchise tax which is present here and which the Supreme Court has said saves a true franchise tax from operating as an income tax. If a corporation is dissolved, has ceased operating or has withdrawn from Wisconsin during the tax year, it is not subject to the franchise tax, regardless of the amount of income earned during the year.[4] However, an income tax imposes a tax on income earned in or attributable to Wisconsin business operations regardless of whether the corporation ceases doing business in the state during the tax year. An income tax is levied on the income earned by the corporation, while a valid, nondiscriminatory franchise tax is measured by the income of the corporation. The *Educational Films* court noted that other forms of excise tax have been upheld, although the statutory measure of the tax included securities constitutionally immune from any form of direct taxation. *Id.*, 282 U.S. at 390.

Educational Films answered the taxpayers' argument that a tax measured by income is only "formalistically" different from a tax levied on income as follows:

> It is said that there is no logical distinction between a tax laid on a proper object of taxation, measured by a subject-matter which is immune, and a tax of like amount imposed directly on the latter; but it may be said with greater force that there is a logical and practical distinction between a tax laid directly upon all of any class of government instrumentalities, which the Constitution

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[4] Such a corporation files an income tax [return] as its final return. Income from obligations of the United States and instrumentalities is not subject to the corporate income tax.

> impliedly forbids, and a tax such as the present which can in no case have an incidence, unless the taxpayer enjoys a privilege which is a proper object of taxation, and which would not be open to question if its amount were arrived at by any other non-discriminatory method.
>
> This court, in drawing the line which defines the limits of the powers and immunities of state and national governments, is not intent upon a mechanical application of the rule that government instrumentalities are immune from taxation, regardless of the consequences to the operations of government. The necessity for marking those boundaries grows out of our constitutional system, under which both the federal and the state governments exercise their authority over one people within the territorial limits of the same state. The purpose is the preservation to each government, within its own sphere, of the freedom to carry on those affairs committed to it by the Constitution, without undue interference by the other. [citations omitted]
>
> Having in mind the end sought, we cannot say that the rule applied by this court for some seventy years, that a non-discriminatory tax upon corporate franchises is valid, notwithstanding the inclusion of tax exempt property or income in the measure of it, has failed of its purpose, or has worked so badly as to require a departure from it now; or that the present tax, viewed in the light of actualities, imposes any such real or direct burden on the federal government as to call for the application of a different rule.

282 U.S. at 391-92.

The inclusion of tax-exempt income in the measure of a corporate franchise tax does not invalidate the tax. We therefore conclude that sec. 71.01(2), Stats., insofar as it imposes a franchise tax on corporations measured by income which includes earnings on federal obligations, does not violate the supremacy or borrowing clauses of the United States Constitution.

III.

IS SECTION 71.01(2) STATS., UNCONSTITUTIONAL IF IT WAS ENACTED TO REACH CORPORATE INCOME FROM FEDERAL OBLIGATIONS?

The taxpayers argue that even if sec. 71.01(2), Stats., imposes a true franchise tax, the tax is nonetheless invalid because the principal purpose of the statute is to reach and tax otherwise unreachable federal income. The taxpayers rely on *Miller v. Milwaukee*, 272 U.S. 713 (1927) and *Macallen Co. v. Massachusetts*, 279 U.S. 620 (1929). We cannot deny that there is language in these decisions to support the taxpayers' contention. However, we believe the holding of those cases has been so eroded by subsequent Supreme Court decisions that, insofar as they may be interpreted to invalidate otherwise non-discriminatory franchise taxes, they are no longer precedential.

The holdings of *Miller* and *Macallen* are summarized in the following statement of the *Macallen* court:

> On the one hand, the state is at liberty to tax a corporation with respect to the doing of its business. On the other hand, the state cannot tax the income of the corporation derived from non-taxable securities. It necessarily follows that the legislature may not, by an artful use of words, deprive this court of its authority to look beyond the words to the real legislative purpose. And the power and the duty of the court to do so is of great practical importance. For when the aim of the legislature is simply to tax the former, it is less likely to impose an injurious burden upon the latter than when the aim is directed primarily against the latter.

Macallen, 279 U.S. at 630.

In *Educational Films*, 282 U.S. at 392, the Court stated that *Macallen* was not a departure from the rule that a non-discriminatory tax upon corporate franchises is valid, notwithstanding the inclusion of tax exempt property or income in the measure of it. *Macallen* was said to

rest on the distinguishing fact that the tax exempt securities were included in the franchise tax by an amendment specifically intended to reach the income from tax exempt bonds which had previously not been included in the measured of the tax. *Educational Films* at 392. This is precisely the distinguishing fact which the taxpayers claim is here present.

However, *Pacific Company v. Johnson*, 285 U.S. 480 (1932), and *Tradesmens Nat. Bank v. Oklahoma Tax Com.*, 309 U.S. 560 (1940), make clear that the test to be applied to a corporate franchise tax which is measured by income, including income which is immune from a direct tax, is that if the taxation act "operates to measure the tax on the corporate franchise by the entire net income of the corporation, without any discrimination between income which is exempt and that which is not, [then] there is no infringement of any constitutional immunity." *Pacific Company*, 285 U.S. at 496; *Tradesmens Nat. Bank*, 309 U.S. at 566-67.

We conclude that the legislative purpose in enacting a taxing statute is irrelevant as long as the tax operates in a constitutional way. In *Pacific Company*, 285 U.S. at 495-96, the Court said:

> A taxing statute, like others, must be read as a whole, as it stands on the statute books at its applicable date, and the legislative purpose in enacting it must be taken, regardless of forms of words, to envisage the obvious consequences which flow from its operation. . . .[T]he present act must be judged by its operation rather than by the motives which inspired it.

In *Tradesmens Nat. Bank*, the Court made clear that *Miller* and *Macallen* were not to be read to require a contrary conclusion. The Court stated, "We do not now decide just what circumstances, *if any*, would bring a situation within the precise scope of the Macallen Co. Case, *assuming that case still has vitality*." *Tradesmens Nat. Bank*, 309

U.S. at 566 (emphasis added). Because sec. 71.01(2), Stats., meets the *Pacific Company-Tradesmens Nat. Bank* test, it is constitutional.

IV.

DOES 31 U.S.C. SEC. 3124 REQUIRE THAT INCOME EARNED ON FEDERAL OBLIGATIONS BE EXCLUDED FROM SEC. 71.01(2), STATS?

Section 31 U.S.C. sec. 3124 (1982) provides:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both to be considered in computating a tax, except –
>
> (1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and
>
> (2) an estate or inheritance tax.

This statute is a revision and recodification of former 31 U.S.C. sec. 742 (1976) which provided:

> Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate or inheritance taxes.

The last sentence of this statute was added by a 1959 amendment. Pub. L. No. 86-346, sec. 105(a), 73 Stat. 621. The taxpayers contend that the amendment demonstrates congress's abandonment of formalistic distinctions between taxes. However that may be, the statute excepts from the

exemption non-discriminatory franchise taxes imposed on corporations. Since we have concluded that sec. 71.01(2), Stats., imposes such a tax, it is excepted from the exemption extended by 31 U.S.C. sec. 3124 (1982).

By the Court.–Judgment affirmed.

State of Wisconsin
Circuit Court
Dane County

SAVINGS LEAGUE OF WISCONSIN, LTD., EQUITABLE SAVINGS & LOAN ASSOCIATION, LIBERTY SAVINGS & LOAN ASSOCIATION, and MARATHON COUNTY SAVINGS & LOAN ASSOCIATION,

Plaintiffs,

vs.

THE DEPARTMENT OF REVENUE OF THE STATE OF WISCONSIN and MICHAEL LEY, as Secretary of Department of Revenue,

Defendants.

83 CV 2318

MEMORANDUM DECISION AND ORDER

Plaintiffs maintain that the corporate franchise tax imposed by sections 71.03(1)(c) and (d), Stats., violates 31 U.S.C. section 742 and Art. VI (supremacy clause) and Art. I, Sec. 8, Cl. 2 (borrowing clause) of the U.S. Constitution, because it is really an income tax that invalidly includes interest and dividends on U.S. government obligations as net income for purposes of taxation. Plaintiffs and defendants each move for summary judgment on the legal issue presented.

Since I conclude that Wisconsin's franchise tax is not an income tax, and find section 71.03(1)(c) and (d), Stats., valid, I grant summary judgment to defendants.

FACTS

In 1965, the Wisconsin legislature enacted the Wisconsin franchise tax, which requires every corporation to pay a tax for the privilege of doing business within the state. The franchise tax replaced the corporate income tax, which formerly all corporations were required to pay. The franchise tax differed from the income tax in that it includes all amounts derived from stocks and obligations of the United States government in the computation of net income. See, secs. 71.03(1)(c) and (d), Stats.

On May 6, 1983, plaintiffs, the Wisconsin League of Financial Institutions, Ltd. (formerly the Savings League of Wisconsin, Ltd.), Equitable Savings & Loan Association, Liberty Savings & Loan Association, and Marathon Savings & Loan Association brought an action pursuant to section 806.04, Stats., for declaratory relief against the Wisconsin Department of Revenue (DOR) alleging that the Wisconsin franchise tax is really an income tax; and that therefore sections 71.03(1)(c) and (d), Stats., which require amounts derived from stocks and obligations of the U.S. government to be used in the computation of net income, violate 31 U.S.C section 742, and the supremacy and borrowing clauses of the U.S. Constitution. Art. VI and Art. 1, Sec. 8, Cl. 2, U.S. Constitution.

The parties filed a stipulation of facts with the court on October 21, 1985.

STATUTES INVOLVED

Section 3124 of Title 31, United States Code, provides in part as follows:

> Section 3124. Exemption from taxation
>
> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except –

(1) a nondiscriminatory franchise tax or another non-property tax instead of a franchise tax, imposed on a corporation; . . .

Section 71.01(2), Stats., provides in part as follows:

71.01. Imposition of tax; exempt income

(2) Franchise tax on corporations. For the privilege of exercising its franchise or doing business in this state in a corporate capacity . . . every domestic or foreign corporation . . . shall annually pay a franchise tax according to or measured by its entire net income of the preceding income year at the rates set forth in s. 71.09(2m). Every corporation organized under the laws of this state shall be deemed to be residing within this state for the purposes of this franchise tax. All provisions of chs. 71 and 73 relating to net income taxation of corporations shall apply to franchise taxes imposed under this subsection, unless the context requires otherwise.

Section 71.03(1)(c) and (d), Stats., provide as follows:

71.03 Gross income and exclusions

(1) Inclusions. "Gross income", as used in determining taxable income of corporations under this chapter, shall include:

* * *

(c) All interest derived from money loaned or invested in notes, mortgages, bonds or other evidence of debt of any kind whatsoever.

(d) All dividends.

DECISION

Since the parties herein have stipulated to the material facts, all that remains is an issue of law: therefore summary judgment is appropriate. *Radlein v. Industrial Fire and Casualty Insurance Co.*, 117 Wis. 2d 605, 609 (1984). The construction of a statute in relation to a given

set of facts is a question of law. *Tahtinen v. MSI Insurance Co.*, 122 Wis. 2d 158, 166 (1985).

Whether Wisconsin's corporate franchise tax is in reality an income tax has been recently addressed by another branch of the Dane County Circuit Court. Judge Mark Frankel held in *Mobil Oil Corporation v. Michael W. Ley*, Dane County Circuit Court, Case No. 82 CV 4819 (filed April 3, 1986), that the franchise tax is not an income tax. I find the analysis in that case persuasive and adopt Judge Frankel's reasoning as follows:

> "Case law clearly establishes the legal distinction between a corporate income tax, which is levied on net income, and a corporate franchise tax, which is measured by net income. In *Educational Films Corp. v. Ward*, 282 U.S. 379 (1930), the United States Supreme Court upheld a tax very similar to Wisconsin's corporate franchise tax .... In so holding, the Court stated:
>
> "If we look to the operation of the present statute, it is plain that it can have no application independent of the corporation's enjoyment of the privilege of exercising its franchise. If appellant had ceased to do business before November 1, 1929, it would not have been subject to any tax under this statute, although it had received, during its preceding fiscal year, income which the statute makes the measure of the tax. Since it can be levied only when the corporation both seeks or exercises the privilege of doing business in one year and has been in receipt of net income during its preceding fiscal year, the tax, whatever descriptive terms are properly applicable to it, obviously is not exclusively on income apart from the franchise. *Educational Films Corp. v. Ward*, 282 U.S. at 388."
>
> *Mobil Oil Corporation*, supra, at 28-29.

Judge Frankel also relied on *Reubens L. Anderson-Cherne v. Commissioner of Taxation*, 226 N.W.2d 611, 615 (Minn. 1975), in which the Minnesota Supreme Court stated:

> The United States Supreme Court has stated the general rule that a tax is a franchise tax rather than an income tax if it requires that the earning of the income and the exercising of the privilege of doing business in corporate form coincide before imposing tax liability. *Reubens L. Anderson-Cherne*, supra, at 614.

It is clear that the Wisconsin franchise law requires the earning of the income in the previous year and the exercise of the privilege of doing business in the state in the current year before a corporate franchise tax is imposed. Therefore, the franchise tax is clearly not an income tax, but rather is a tax on the privilege of exercising the corporate franchise in the State of Wisconsin. As Judge Frankel noted: "Article VIII, Sec. 1 of the Wisconsin Constitution grants the legislature explicit authority to levy taxes on privileges as well as incomes. Under the case law governing privilege taxes, the State can legitimately measure a privilege tax by corporate gross receipts, income, or property. See e.g., *Beals v. State*, 139 Wis. 544, 545, 556, 557, 121 N.W. 347 (1909); *Northwestern Mut. L. Ins. Co. v. State*, 163 Wis. 484, 486, 499, 155 N.W. 609 (1915), aff'd 247 U.S. 132 (1918). In so doing it does not impose a tax on corporate gross receipts, income or property. . . ." *Mobil Oil Corporation*, supra, at 30. I agree.

Finally, it is not disputed that interest and dividends on U.S. government obligations are allowable inclusions in computing net income for valid franchise tax. See, section 3124, Title 31, U.S. Code.

CONCLUSION AND ORDER

For the reasons stated above, and based on the entire record herein, I conclude that Wisconsin's franchise tax is not an income tax, and that the inclusions of interest and dividend on U.S. government obligations does not violate either the supremacy or the borrowing clause of the U.S. Constitution. Accordingly, I grant summary judgment for defendants and declare sections 71.03(1)(C) and (d), Stats., valid.

Dated this 20th day of August, 1986.

BY THE COURT:

/s/ Angela B. Bartell

ANGELA B. BARTELL
Circuit Judge

cc: Robert A. Schnur, 250 E. Wisconsin Ave., Milwaukee, WI 53202

AAG Edward S. Marion, P. O. Box 7857, Madison, WI 53707-7857

In The
Court of Appeals, District IV
of the State of Wisconsin

SAVINGS LEAGUE OF WISCONSIN, LTD., EQUITABLE SAVINGS & LOAN ASSOCIATION, LIBERTY SAVINGS & LOAN ASSOCIATION, and MARATHON COUNTY SAVINGS & LOAN ASSOCIATION,

Plaintiffs-Petitioners

v.

THE DEPARTMENT OF REVENUE OF THE STATE OF WISCONSIN and W. MICHAEL LEY, as Secretary of Department of Revenue,

Defendants-Respondents

Appeal No. 86-1825

[FILED JULY 26, 1988]

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

Notice is hereby given that Savings League of Wisconsin, Ltd., Equitable Savings & Loan Association, Liberty Savings & Loan Association, and Marathon County Savings & Loan Association, Plaintiffs-Petitioners above named, hereby appeal to the Supreme Court of the United States from the final judgment of the Court of Appeals, District IV, of Wisconsin, entered on October 15, 1987. The Court of Appeals decision affirmed the judgment entered in Dane County Circuit Court on September 29, 1986, pursuant to the Memorandum Decision and Order of that Court dated August 20, 1986.

The Wisconsin Supreme Court issued an order on May 3, 1988 denying Petitioners-Appellants' Petition for Review of the Wisconsin Court of Appeals' decision.

This appeal is taken pursuant to 28 U.S.C. §1257(2).

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CERTIFICATE OF SERVICE

I, Robert A. Schnur, do hereby certify that on this 26th day of July, 1988, a copy of the foregoing Notice of Appeal to the Supreme Court of the United States was mailed, first class postage prepaid, to Donald J. Hanaway, Attorney General, Room 114, East State Capitol, Madison, Wisconsin 53702 and Edward S. Marion, Assistant Attorney General, Justice Building, P. O. Box 7857, Madison, Wisconsin 53707-7857.

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Supreme Court, U.S.
FILED
SEP 1 1988
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-230

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1988

SAVINGS LEAGUE OF WISCONSIN, LTD., EQUITABLE SAVINGS & LOAN ASSOCIATION, LIBERTY SAVINGS & LOAN ASSOCIATION, and MARATHON COUNTY SAVINGS & LOAN ASSOCIATION,

Appellants,

v.

THE WISCONSIN DEPARTMENT OF REVENUE and W. MICHAEL LEY, as secretary of the Department of Revenue,

Appellees.

ON APPEAL FROM THE COURT OF APPEALS
OF WISCONSIN, DISTRICT IV

MOTION TO DISMISS OR AFFIRM

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QUESTIONS PRESENTED

1. Did the appellants fail to properly raise the questions regarding the purpose and effect of the Wisconsin corporate franchise tax in the state courts?

2. Does there exist a substantial federal question, in light of the several decisions of this Court holding that a franchise tax measured by net income is constitutional notwithstanding that interest from federal obligations are included in the measure of the tax?

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The appellees move to dismiss this appeal or, in the alternative, to affirm the judgment of the Court of Appeals of Wisconsin, on the ground that the question presented by the appellants is so insubstantial as not to warrant further argument and that, in any event, the appellants failed to properly present their case in the state courts.

ARGUMENT

I. THIS APPEAL SHOULD BE DISMISSED FOR WANT OF A SUBSTANTIAL FEDERAL QUESTION IN LIGHT OF THE SEVERAL DECISIONS OF THIS COURT UPHOLDING STATE FRANCHISE TAXES MEASURED BY NET INCOME INCLUDING INTEREST FROM FEDERAL OBLIGATIONS.

A. The constitution permits state taxation measured by income, including interest on federal obligations.

As certainly as the states cannot tax the interest on federal obligations,

the states can tax corporate franchises although measured by net income, including such interest. Tradesmens Nat. Bank v. Oklahoma Tax Comm., 309 U.S. 560 (1940); Peo. of the State of New York ex rel. Northern Finance Corporation v. Lynch, 290 U.S. 601 (1933); Pacific Co. v. Johnson, 285 U.S. 480 (1932); Educational Films Corporation v. Ward, 282 U.S. 379 (1931); Flint v. Stone Tracy Co., 220 U.S. 107 (1911); First American Nat. Bank v. Olsen, 751 S.W.2d 417 (Tenn. 1987), appeal dismissed sub nom First American National Bank of Knoxville v. Taylor, 108 S. Ct. 1460 (1988); Dept. of Revenue v. First Union Nat. Bk., 513 So.2d 114 (Fla. 1987), appeal dismissed, 108 S. Ct. 1253 (1988); Garfield Trust Co. v. Director, Div. of Tax., 508 A.2d 1104 (N.J.), appeal dismissed, 107 S. Ct. 390 (1986); Reuben L. Anderson-Cherne,

Inc. v. Com'r of Taxation, 226 N.W.2d 611, appeal dismissed, 423 U.S. 886 (1975); Hellerstein, State Taxation, Corporate Income and Franchise Taxes (1983) sec. 7.1, pp. 263-66; Powell, The Waning of Intergovernmental Tax Immunities, 58 Harv. L. Rev. 633 (1945).[1]

The issue was fully considered by this Court in Educational Films. Section 209 of the New York Tax Law, entitled "Franchise tax on corporations based on net income," imposed an annual tax on all corporations "[f]or the privilege of exercising its franchise . . . in a corporate or organized capacity . . . to

---

[1]Equally clearly, the states can tax corporate franchises measured by the value of property, including federal obligations. Home Ins. Co. v. New York, 134 U.S. 594 (1890); Society for Savings v. Coite, 6 Wall. 594 (1867); Werner Machine Co. v. Director of Division of Tax, 31 N.J. Super. 444, 107 A.2d 36, aff'd, 17 N.J. 121, 110 A.2d 89 (1954), 350 U.S. 492 (1956).

be computed . . . upon the basis of [the corporations'] entire net income . . . ." 282 U.S. at 385 n.1. The definition of net income expressly included "all dividends received on stocks and all interest received from federal. . . bonds." Id. at 386.

In rejecting the taxpayer's challenge to the tax, the Court stated that while the instrumentalities of the federal government cannot directly be taxed, "the privilege of exercising the corporate franchise" can be taxed although the measure of the tax includes income or property which can not directly be taxed. Id. at 388.

The issue was presented again in Pacific Co. The "California Bank and Corporation Franchise Tax Act" imposed a tax on corporations "for the privilege of doing business within the State,"

measured by net income, including "all income received from federal . . . bonds." 285 U.S. at 488. The taxpayer contended that the tax was "in effect" a tax on income and prohibited. The Court rejected the challenge on the authority of Educational Films and earlier decisions.

In Tradesmens Nat. Bank, the Court considered a portion of the "Oklahoma Income Tax Law" laying a tax on national banking associations doing business in that state, measured by net income, including interest on federal obligations. Reviewing its earlier decisions, the Court stated:

> The power of a state to levy a tax on a legitimate subject, such as a franchise, measured by net assets or net income including tax-exempt federal instrumentalities or

> their income is likewise well settled.

309 U.S. at 564.

In summary, the constitution permits the states to impose corporate franchise taxes measured by net income, including interest on federal obligations. This is precisely what the Wisconsin statute does.

B. Title 31 U.S.C. § 3124(a) permits state franchise taxation measured by income, including interest on federal obligations.

Title 31 U.S.C. § 3124 authorizes a state to levy "a nondiscriminatory franchise tax . . . imposed on a corporation," although such a tax requires "the interest on [federal] obligation[s] . . . to be considered in computing [the] tax."

The appellants do not contend that the Wisconsin tax is discriminatory. Therefore, the tax is permissible under this statute. See First Nat. Bank of Atlanta v. Bartow County Bd., 105 S. Ct. 1516 (1985); American Bank & Trust Co. v. Dallas County, 463 U.S. 855 (1983).

C. The Wisconsin tax is a bona fide franchise tax.

1. Wisconsin's purpose in enacting the franchise tax law is irrelevant.

The appellants contend that the Wisconsin tax is invalid because it allegedly was enacted for the purpose of reaching otherwise untaxable income. Assuming the accuracy of this contention, it is irrelevant.

As already noted, this Court has refused to attempt to assess motive in

judging the constitutionality of state franchise tax laws measured by income, including interest on federal obligations. In only one case, Macallen Co. v. Commonwealth of Massachusetts, 279 U.S. 620 (1929), did the Court consider legislative purpose in enacting a franchise tax. This decision, however, has been repudiated by the Court.

In Educational Films, the taxpayer, like the appellants herein, pointed to statutory amendments as allegedly evincing an improper intention to tax federal obligations, and relied, like the appellants, on Macallen. The Court stated:

> Reference is made to the legislative history of the statute.
>
> . . . .
>
> There is nothing to suggest that the Legislature could at any time have had in mind the addition of income from copyrights to the measure

> of the tax, or that the statute or the amendments were adopted "for the very purpose of subjecting" it "pro tanto to the burden of the tax," which was declared to be the vice of the statute in Macallen Co. v. Massachusetts, supra, page 631 of 279 U.S., 49 S. Ct. 432, 73 L. Ed. 874. That the royalties play some part in the measure of the tax is the result of the application of the general language of the statute to particular circumstances to which the statute makes no specific reference.

Educational Films, 282 U.S. at 393-94.

Allegedly improper legislative motive was considered at length in Pacific Co. The Court tracked the history of the California franchise tax and determined that there was a purpose to reach federal obligations, but that such a purpose did not invalidate the statute.

> The view that a tax, although levied on a taxable subject, may be deemed invalid because purposely devised to include a non-taxable subject in its measure, receives only a

> limited and qualified support from Miller v. Milwaukee, supra. . . . [O]n its face, did [the statute] more than exhibit an intention of the one sovereignty to include in the dividends taxed, those derived from income from a non-taxable instrumentality of the other, together with income from all other sources. That admittedly would have been permissible; [citations omitted]. But it was the exclusion from the measure of the tax of all income except from federal bonds which rendered the tax invalid.
>
> . . . .
>
> But the present case is not one of discrimination. There is no attempt, as in Miller v. Milwaukee, supra, to measure the tax by exempt income while excluding from the measure all taxable income. The state seeks to do only what its contract permits it to do, to measure the franchise tax by all the net income of the taxpayer.

Id. at 492-94. The Court also rejected the taxpayer's reliance upon Macallen:

> But the state of California, in its legislation, has indulged in no reversal of policy so far as the measure-

> ment of the franchise tax is concerned and in no discrimination either in favor of or against tax exempt income. The entire history of its legislation discloses only that it has sought, in good faith, to conform its scheme of taxation of corporations to a permitted method of taxing national banks, to avoid discrimination against the latter. It has effected its purpose by adopting, in a single legislative act, a new form of privilege tax on corporations measured by their net income, without any form of discrimination as to the sources of the income included in the measure, differing in this respect in no material way from the similar tax upheld in Flint v. Stone Tracy Co. and in Educational Films Corporation v. Ward, supra.

Pacific Co. at 494-95.

Finally, in Tradesmens Nat. Bank, the Court again discounted legislative purpose in judging a franchise tax.

In all three cases just discussed, the legislative history disclosed support for the claim that state tax laws were either created or amended for the purpose

of including interest on federal obligations in the measure of a franchise tax. In each case, the Court held that the state legislature was doing no more than taking advantage of its constitutional right to include such interest. Macallen (to the limited extent it was recognized as having any "vitality") was limited to its unique facts.

Macallen was questioned by the Court again in United States v. Detroit, 355 U.S. 466, 472 n.2 (1958):

> The Government also places reliance on Macallen Co. v Massachusetts, 279 US 620, 73 L ed 874, 49 S Ct 432, 65 ALR 866. The weight of that case as a precedent was substantially impaired by its narrow distinction in Educational Films Corp. v Ward, 282 US 379, 392, 75 L ed 400, 407, 51 S Ct 170, 71 ALR 1226, and the reasoning of the Court in Pacific Co. v. Johnson, 285 US 480, 495, 76 L ed 893, 899, 52 S Ct 424. Later in New York ex rel. Northern Finance Corp. v.

> Lynch, 290 US 601, 78 L ed 528, 54 S Ct 230, a case which seems indistinguishable from Macallen on its facts, the Court in a per curiam opinion upheld the same kind of state tax which it had struck down in Macallen.

The Court explicitly held that Macallen "no longer has precedential value" in Phillips Chemical Co. v. Dumas Ind. Sch. Dist., 361 U.S. 376, 382 (1960), accord, Washington v. United States, 460 U.S. 536, 542 n.5.

The New Jersey court in Werner Machine Co. stated: "The dicta in the Macallen case has not borne any healthy progeny, and has subsequently attained prominence more by reason of its circumvention than by its adoption." 107 A.2d at 38. The court rejected the taxpayer's contention that the Legislature's purpose to include the value of federal obligations in computing a franchise tax measured by net worth

invalidated the tax. The court stated: "[T]he mere intent of the Legislature to do that which the constitution permits can not deprive legislation of its constitutional validity on account of the motives that may have inspired it." Id. at 38. This Court affirmed the decision of the New Jersey courts, in the basis of its earlier decisions, without even considering the motive or purpose of the state legislature. Werner Machine Co., 350 U.S. 492.

2. The economic effect of the statute has nothing to do with its validity.

The appellants argue that this Court must disregard the Wisconsin Legislature's characterization of Wis. Stats. § 71.01(2) as a franchise tax and hold that it is an income tax because the

"economic effect" of the two taxes are the same. This argument should be rejected. In the first place, the Court cannot determine the economic effects of the franchise and income taxes because no findings on these questions of fact were made or even sought below. In the second place, economic effect is not material to the validity of the tax.

The appellants cite Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), for the proposition that it is "absurd" and "practically impossible" to distinguish between an income tax and a franchise tax measured by income (Jurisdictional Statement at 16). The Court did not state anything nearly like the appellants' assertion. The language the appellants rely upon is a composite of the last sentence of one paragraph, discussing the application of the rule of

one case to the facts of another, and a sentence from the middle of a paragraph four pages later, in a different context entirely.

At 430 U.S. at 285, the Court was comparing two Commerce Clause cases: one permitting the taxation of income from interstate commerce and the other prohibiting the taxation of a franchise measured by the same net income. What the Court found "absurd" was, not the distinction between an income tax and a franchise tax measured by net income, but the Court's decision in Spector Motor Service v. O'Connor, 340 U.S. 602 (1951), invalidating the franchise tax measured in part by income earned in interstate commerce. Far from departing from its long-standing recognition of the distinction between income and income-measured franchise taxes, the Court, in

overruling Spector, was giving effect to franchise taxes measured by interstate income.

In the second sentence quoted by the appellants (430 U.S. at 289), the Court stated that the use of particular words in a taxing statute does not "necessarily" carry with it any economic significance and does not answer whether the tax produces a "forbidden effect." This statement alone is unassailable, but the "forbidden effect" is a burden on interstate commerce, which has nothing to do with this case or the analysis appropriate to determine the validity of Wis. Stats. § 71.01(2).

In analyzing the validity of state franchise taxes the Court has not looked beyond the face of the statute to examine economic effects. In Werner Machine Co., the Court considered the question:

> Appellant argues further that even if this is a franchise tax, it must fall because its effect is the same as if it had been imposed directly on the tax-exempt federal securities. Since the tax remains the same whatever the character of the corporate assets may be, no claim can be sustained that this taxing statute discriminates against the federal obligations. And since this is a tax on the corporate franchise, it is valid despite the inclusion of federal bonds in the determination of net worth. This Court has consistently upheld franchise taxes measured by a yardstick which includes tax-exempt income or property, even though a part of the economic impact of the tax may be said to bear indirectly upon such income or property.

350 U.S. at 493-94. Moreover, 31 U.S.C. § 3124, explicitly allowing franchise taxes measured by federal obligations, contains no economic criteria; the franchise tax must only be nondiscriminatory.

Referring to 31 U.S.C. § 742, the predecessor of § 3124, the Court recently

observed that the Court has long recognized as valid the distinction between a tax "on" federal obligations (invalid) and a tax on a "discrete transaction," such as a franchise, only measured by income or the value of federal obligations, even though this distinction is "formal but economically meaningless." American Bank & Trust Co., 103 S. Ct. at 3372.

Thus, even if economic effect were relevant, the only prohibited effect would be discrimination against the United States. In a recent decision applying 31 U.S.C. § 3124, the Court stated: "Where . . . the economic but not the legal incidence of the tax falls on the federal government such a tax generally does not implicate the constitutional immunity if it does not discriminate against holders of federal

property or those with whom the Federal Government deals." Memphis Bank and Trust Co. v. Garner, 459 U.S. 392, 103 S. Ct. 692, 696 (1983).

Thus, even if the economic incidence of the Wisconsin tax fell on the federal government, the tax is valid since the federal government is not discriminated against.

3. Wisconsin Stats. § 71.01(2) is a bona fide franchise tax because it can have no application independent of the corporation's enjoyment of the privilege of exercising its franchise.

In Educational Films Corporation, the taxpayer attacked New York's corporate franchise tax measured by net income as "in reality a tax on income,

and as such falls within the class of taxes which concededly may not be directly imposed on federal instrumentalities." 282 U.S. at 387. The Court looked to "the operation" of the tax to determine its true character:

> If we look to the operation of the present statute, it is plain that it can have no application independent of the corporation's enjoyment of the privilege of exercising its franchise. If appellant had ceased to do business before November 1, 1929, it would not have been subject to any tax under this statute, although it had received, during its preceding fiscal year, income which the statute makes the measure of the tax. Since it can be levied only when the corporation both seeks or exercises the privilege of doing business in one year and has been in receipt of net income during its preceding fiscal year, the tax, whatever descriptive terms are properly applicable to it, obviously is not exclusively on income apart from the franchise.

Id. at 388.

Like the statute upheld in Educational Films Corporation, Wis. Stats. § 71.01(2), can have no application independent of a corporation's enjoyment of the privilege of exercising its franchise.

Wisconsin Stats. § 71.01(2), Stats., is entitled "FRANCHISE TAX ON CORPORATIONS," and imposes on corporations a tax "[f]or the privilege of exercising its franchise or doing business in this state in a corporate capacity." This, the Legislature's characterization of the tax as a franchise tax, must be respected.

In interpreting a tax statute to determine the true nature of the tax imposed, "the declaration of the lawmaking power is entitled to much weight." Flint, 220 U.S. at 145 (upholding a state tax as a franchise notwithstanding its effect on federal

property). In rejecting a taxpayer's claim that a self-styled franchise tax was really an income tax, the Court in Werner Machine Co., 350 U.S. at 493, held it significant that "the statute expressly declares [the tax] to be a franchise tax." The California Supreme Court had earlier ruled that the tax was a bona fide franchise tax. This Court found "no basis . . . for not accepting" that conclusion. Id. at 493.

Similarly, the Wisconsin tax declares itself to be a franchise tax and the Wisconsin courts have upheld it as such. This court has no basis for not accepting this result.

II. APPELLANTS FAILED TO PROPERLY PRESENT THEIR ISSUES RELATING TO THE ALLEGED PURPOSE AND EFFECT OF THE WISCONSIN TAX IN THE STATE COURTS.

In their Jurisdictional Statement, the appellants contend that the purpose of the Wisconsin corporate franchise tax is undisputably to tax otherwise exempt federal obligations (Jurisdictional Statement at 6, 11). This is not true. Appellant's complaint did not allege what the purpose of enactment of the corporate franchise tax was. The parties' stipulation of facts was silent with respect to the purpose of the tax. The appellants moved for summary judgment, alleging that there were no disputed material facts requiring a trial. The state took the position that the purpose of the enactment of the tax was not a material fact. The state trial court

made no findings of fact regarding purpose.[3]

Purpose is a question of fact. Since this fact was never litigated in the state courts, it cannot properly be reviewed in this Court.

The appellants contend that the economic effect of the Wisconsin tax is the same as if it were a tax on income. As in the case of the alleged purpose of the tax, the alleged economic effect of the tax was not litigated in the state courts. The complaint did not allege what the economic effect of the tax was

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[3]The appellants inform the Court that the trial court "did not address" the issue of purpose (Jurisdictional Statement at 7). This is not surprising since purpose was not placed in issue by the appellants.

nor was effect mentioned in the party's stipulation of facts.[4]

Again, we note that it was the appellants who moved for summary judgment, alleging no factual disputes. Nowhere in the record will the Court find a basis for concluding that economic effect was litigated to any extent whatsoever. Thus, far from demonstrating that the economic effect of the Wisconsin franchise tax is the same as that of an income tax, the appellants waived their opportunity to attempt to do so by moving for summary judgment.

Finally, the appellants present to this Court for the first time changes in the Wisconsin statutes which they believe

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[4]This could explain why, as stated in the appellants (Jurisdictional Statement at 7, 8), the trial court did not address effect and why the court of appeals did not address it "explicitly."

further jeopardize the constitutionality of the Wisconsin tax (Jurisdictional Statement at 19, 21, 22). None of these changes have been presented to the state courts.[5]

CONCLUSION

Since this Court has so frequently upheld the propriety of tax statutes such as the Wisconsin Corporate Franchise Tax, since the appellants have, in any event, failed to properly raise questions of the purpose and effect of the Wisconsin tax in the state courts and since the appellants have never presented for review by the Wisconsin courts the

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[5]The appellants concede that a change in Wis. Stats. § 71.042(2) was made while a petition for review of the decision of the court of appeals was pending in Wisconsin Supreme Court (Jurisdictional Statement at 22 n.7). Yet, they did not call it to the Wisconsin Supreme Court's attention.

statutory amendments argued in their Jurisdictional Statement, this Court should either dismiss the appeal or affirm the decision of the Court of Appeals of Wisconsin without further briefing or argument.

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No. 88-230

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In The

Supreme Court of the United States

October Term, 1988

SAVINGS LEAGUE OF WISCONSIN, LTD., EQUITABLE SAVINGS & LOAN ASSOCIATION, LIBERTY SAVINGS & LOAN ASSOCIATION, and MARATHON COUNTY SAVINGS & LOAN ASSOCIATION

Appellants,

v.

WISCONSIN DEPARTMENT OF REVENUE and W. MICHAEL LEY, as Secretary of the Department of Revenue,

Appellees.

ON APPEAL FROM THE COURT OF APPEALS, DISTRICT IV, OF WISCONSIN

REPLY TO APPELLEES' MOTION TO DISMISS OR AFFIRM

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INTRODUCTORY STATEMENT AS TO CONTENTS OF REPLY BRIEF

As this is a reply brief authorized by Rule 16.5, Rules of the Supreme Court of the United States, Appellants will present herein only direct reply to Appellees' Argument, and will not repeat or reiterate the other portions included as required in Appellants' Jurisdictional Statement.

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REPLY TO APPELLEES' ARGUMENT

I. CONTRARY TO THE APPELLEES' ASSERTION, IT *IS* THE "ECONOMIC EFFECT" OF A TAX STATUTE (AND NOT ITS NOMENCLATURE) THAT DETERMINES ITS VALIDITY

On page 14 of the Appellees' Motion to Dismiss or Affirm (referred to hereinafter as the "Motion"), they state

concisely the essence of their argument, which is that "[t]he economic effect of the [tax] statute has nothing to do with its validity." Instead, they contend, this Court is prohibited from looking "beyond the face of the statute" (Motion, p. 17) and it must therefore continue to recognize the distinction between an "income" tax and a "franchise" tax measured by income, even though that distinction might be "economically meaningless" (Motion, p. 19). It is apparent that the lower courts adopted the same reasoning in reaching their conclusions in this case and this Court is respectfully urged to take the present opportunity to clarify whether this astonishingly formalistic theory of constitutional adjudication has indeed survived into the modern era.

The Appellants rely on *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) in arguing that legislative labels are no longer determinative of the validity of a tax statute but the Appellees contend (Motion, p. 15) that *Complete Auto* does not support "anything nearly like" that proposition. Their analysis of *Complete Auto* is puzzling but, apparently, they are arguing that the *Complete Auto* approach (i.e, ignoring the "particular words" of a statute and focusing instead on its economic effect) is limited to Commerce Clause disputes and that this practical approach does not extend to Supremacy Clause, Borrowing Clause, or 31 U.S.C. §3124 controversies. *Complete Auto*, however, contains no such limitation and, in fact, this Court has analyzed intergovernmental immunities in precisely the same manner. *See, e.g., American Bank and Trust Co., v. Dallas County*, 463 U.S. 855 (1983), invalidating a Texas property tax on bank shares because the tax included in its measure the value of United States obligations owned by the bank; in reaching this conclusion, this Court rejected as "formalistic" the State's argument that, for purposes of the predecessor to 31 U.S.C. §3124, there was a meaningful difference between a tax on corporate shares that included in its measure the value of federal obligations owned by the

corporation and a direct tax on the underlying obligations themselves.

It is of course true that Congress has chosen to exempt bona fide "franchise" taxes from the statutory prohibitions of 31 U.S.C. § 3124 meaning that, before reaching the direct question presented in *American Bank*, it is first necessary to determine whether a tax is or is not a true "franchise" tax. The Appellees (and the lower courts herein) apparently argue that this preliminary step *is* still to be analyzed solely in terms of the label affixed to the tax, meaning presumably that Texas could now avoid the result in *American Bank* by merely relabeling its bank share tax as a "franchise" tax.[1] Perhaps such an emphasis on semantics is statutorily unavoidable with respect to a tax based on the value of corporate assets[2] but, especially in view of *Complete Auto*, it is surely an outmoded and inappropriate method of analyzing what is purely and simply a renamed (and misnamed) income tax.

In summary, this case presents the Court with a significant opportunity to clarify whether, despite *Complete Auto*, *American Bank* and their progeny, there still remains a protected oasis of formalism and semantics in a constitutional area from which so much of this outmoded underbrush has been recently cleared.

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[1] Just as Wisconsin relabeled its corporate "income" tax as a "franchise" tax.

[2] This Court noted in *American Bank* that true "franchise" taxes customarily assess the franchise "at the value of the assets of the business." 463 U.S. at 863, n. 6.

II. THE APPELLEES ARE IN ERROR WHEN THEY CLAIM THAT THIS COURT HAS OVERRULED ITS EARLIER DECISIONS TO THE EFFECT THAT A STATE TAX CAN BE INVALIDATED IF ADOPTED FOR AN IMPROPER PURPOSE

In Appellants' Jurisdictional Statement, it was contended that, under *Macallen v. Massachusetts*, 279 U.S. 620 (1929), the Wisconsin "franchise" tax imposed by Wis. Stat. §71.01(2) should be invalidated because it was adopted for the sole purpose of taxing income from federal obligations. Appellees respond (Motion, pp. 8-13) with a discussion of later cases in which *Macallen* was distinguished on its facts but they ignore the crucial point that this Court has always been careful *not* to overrule *Macallen*. Appellees also contend (Motion, p. 13) that *Macallen* has been held by this Court to be "no longer [of] precedential value" but the cases cited for that proposition (*Phillips Chemical Co. v. Dumas Ind. Sch. Dist.*, 361 U.S. 376 (1960) and *Washington v. United States*, 460 U.S. 536 (1983)) do not so hold. Instead, in each of these cases, the focus of the Court was solely on the Court's understanding that *Macallen* required an ostensibly discriminatory state tax to be examined in isolation rather than by reference to the state's overall tax structure; it was this analytic approach that was rejected in *Phillips Chemical* and *Washington v. United States*, not the broader substantive conclusion of *Macallen* that a state tax (such as the Wisconsin "franchise" tax here at issue) enacted solely to reach otherwise tax-exempt income is invalid. *See e.g.*, 460 U.S. at 542. And see also such recent state Supreme Court decisions as *Federal Products Corp. v. Norberg*, 429 A.2d 447 (R.I. 1981), assuming the continued vitality of *Macallen* and relying thereon for its conclusion.

III. THE APPELLEES ARE ALSO WRONG IN CONCLUDING THAT APPELLANTS FAILED TO PROPERLY PRESENT CRUCIAL FACTUAL INFORMATION TO THE LOWER COURTS

The Appellees' final contention (Motion, pp. 24-27) is that, even if the Appellants are correct in their substantive arguments, they have failed to present to the lower courts crucial factual information necessary to support those arguments. These factual "gaps," the Appellees argue, include (i) evidence to demonstrate the purpose of the Wisconsin legislature in enacting a "franchise" tax as a substitute for the long-standing "income" tax and (ii) evidence to demonstrate that the economic effect of the "franchise tax" is the same as the "income tax."

These alleged factual gaps are non-existent. As to the legislative purpose behind the "franchise" tax; this Court stated in *Miller v. Milwaukee*, 272 U.S. 713 (1927) that:

> A result intelligently foreseen and offering the most obvious motive for an act that will bring it about, fairly may be taken to have been a purpose of the act.

Id. at 715. It was demonstrated below that the only difference of substance between Wisconsin's prior "income" tax and the new so-called "franchise" tax was that the new tax reached (or, rather, purported to reach) interest from federal obligations and this "intelligently foreseen" result was surely the "most obvious" legislative purpose behind the enactment of the new tax. Similarly, as to the "economic effect" of the "franchise" tax vis-a-vis the "income" tax, this Court can properly assume, in the absence of *any* substantive difference on the face of the two statutes, that they must of necessity have the same economic impact and Appellees' argument that this self-evident result requires some type of factual demonstration is disingenuous. *See e.g. Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 284 (1977) in which this Court concluded, in analyzing

Railway Express Agency, Inc. v. Virginia, 347 U.S. 359 (1954)("Railway Express I") and *Railway Express Agency, Inc. v. Virginia*, 358 U.S. 434 (1959)("Railway Express II"),[3] that "there was no real economic difference between" a "license" tax levied *on* gross receipts and a "franchise" tax *measured by* gross receipts; this Court did not require any fact-finding to reach this obvious result, and similarly, no fact-finding is required to determine the economic equivalency of an "income" tax and an identically structured "franchise" tax *measured by* income.

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[3] Railway Express I and Railway Express II were discussed in the Appellants' Jurisdictional Statement, at p. 17 n.4.

CONCLUSION

For the reasons stated in the Appellants' Jurisdictional Statement and in this Reply, this Court is respectfully urged to deny the Appellants' Motion to Dismiss or Affirm, to note probable jurisdiction and to set this case for plenary consideration.

Respectfully submitted,

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